Credit Scores: Credit-Based Insurance Scores

January 19, 2005

Congressional Research Service
https://crsreports.congress.gov
RS21341

SUMMARY

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Credit Scores: Credit-Based Insurance Scores

An insurance score, a type of credit score, is a number produced by a computer scoring model that analyzes a person's credit information (i.e., payment history, collections, balances, and bankruptcies) obtained principally from that person's credit reports. Increasingly, insurers have been using insurance scores as an underwriting factor to evaluate insurance applications, especially for automobile and homeowners insurance, in predicting possible future insurance claims an applicant might generate. Insurers maintain that there is a clear statistical connection between a person's insurance score and the likelihood of that person filing claims, as well as how expensive such claims might be. By using insurance scores, insurers say that they are able to charge lower premiums to most customers who are better risks. On the other hand, some consumer advocates dispute the insurers' position and argue that the use of insurance scores has a disparate effect on minorities, and is merely a new method by which insurers can increase premium rates.

Even though credit scores have been widely used for some time by credit-related businesses such as home mortgage lenders and credit card issuers, the use of insurance scores by insurers is relatively new. The growing discontent regarding the use of credit-based scoring has been reflected in proposed legislation amending the Fair Credit Reporting Act to require additional consumer protections, and in increased litigation. Insurance scores, like other credit scores based on credit reports, are regulated to some degree at the federal level. Unlike other credit scores, however, insurance scores used in the underwriting process are also subject to state insurance laws and regulations. Most of the states have been active in recently reviewing their laws and regulations in this area. Federal legislation in the 108th Congress that would have affected insurance scoring included H.R. 1473, H.R. 2796, H.R. 2622, and S. 1753. The latter two were the House and Senate versions of what would become P.L. 108-159, which mandated a study on the impact of insurance scoring. This report will be updated in the event of significant legislative or regulatory developments.

Background on Insurance Scoring

An insurance score, a type of credit score, is a number produced by a proprietary computer scoring model that analyzes a person's credit history information, such as payment history, collection, balances, and bankruptcies. While credit scores are used by lenders to help them decide whether to offer a person a loan, insurance scores are used by insurers to determine what level of risk a person represents. The information used in credit and insurance score models is obtained principally from credit reports, generated by the three major national credit reporting agencies (CRAs): Equifax, Experian, and Trans Union.[1] CRAs are subject to the consumer protections set forth in the Fair Credit Reporting Act (FCRA).[2] Credit scores have been used widely for some time in credit-related businesses such as banks, home mortgage lenders, and credit card issuers, but the use of insurance scores by insurers is relatively new. FCRA allows CRAs to furnish a credit report without the consumer's permission to an insurer when the report is to be used in connection with the underwriting of insurance. However, FCRA also provides that when any users of credit information from CRAs use such information to take action that is adverse to the consumer, then notification of that action must be given to the consumer.

Over the past several years, insurers increasingly have included credit information from credit reports as factors in insurance underwriting, especially in personal lines of insurance such as automobile and homeowners insurance. There is some indication, however, that credit information may also have some relevance in commercial lines of insurance.[3] It has been estimated that 90% of property insurers now use credit information in some way in their underwriting decisions.[4] Insurers maintain that there is a clear statistical connection between a person's insurance score and the likelihood of that person filing claims, as well as how expensive such claims might be. Thus, even though a good insurance score does not necessarily mean a person is a good driver or a more responsible homeowner, insurers contend that their research has shown that persons with better insurance scores generally file fewer insurance claims and have lower insurance losses. Insurers maintain that as a result of using insurance scores, they can charge lower premiums or give discounts to many customers who otherwise would pay more for insurance, and are also able to offer coverage to more consumers. Many insurers have developed their own scoring models, while others contract with third parties to obtain their insurance scores. Either way, insurers say the link between insurance scores and insurance losses is clear, and point to two possible explanations. The first explanation relates to stress — that people under stress are more likely to have auto accidents, and financial problems are a known cause of stress. The second explanation relates to risk-taking behavior — that people have different aversions to risk, and people with poor insurance scores are more likely to engage in risky behavior and, therefore, more likely to incur losses.

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[1] For additional information on credit scores, see CRS Report RS21298, *Credit Scores: Development, Use and Policy Issues*, by Pauline Smale.

[2] P. L. 91-508, tit. 6, 84 Stat. 1128, 15 U.S.C. 1681 *et seq.*

[3] Richard Dorman, "The Evolution of Credit Scoring," *Journal of the Society of Insurance Research*, Winter, 2002, p. 129.

[4] Albert B. Crenshaw, "Bad Credit, Big Premiums," *Washington Post*, June 18, 2002, p. E1, citing Robert P. Hartwig, chief economist of the Insurance Information Institute.

State insurance laws generally provide that insurance rates cannot be unfairly discriminatory. Some state regulators and consumer advocates insist that insurance scores do in fact discriminate against low-income and minority consumers and that their use should be banned or limited. Critics also say that insurance scores penalize poor people, immigrants, and seniors who may not have credit records. One consumer advocate recently asserted that insurance scores are the most controversial new addition to the rate-setting process, that they allow insurers to double automobile premiums even for drivers whose records are pristine, and that states should ban insurers from using them to set rates.[5] Another consumer advocate has created a separate website to inform insurance consumers about the use of insurance scores and to urge them to get involved in forcing insurers to abandon the practice.[6]

Federal Regulatory Aspects

FCRA allows CRAs to furnish a credit report to an insurer without the consumer's permission if the report is to be used in connection with the underwriting of insurance. However, if any user of credit information from CRAs uses such information to take any adverse action, the person so affected must be given notification of that action. The provisions of FCRA fall under the enforcement jurisdiction of the Federal Trade Commission (FTC), which, in its commentary on FCRA, stated that "An insurer may obtain a consumer report to decide whether or not to issue a policy to the consumer, the amount and terms of coverage, the duration of the policy, the rates or fees charged, or whether or not to renew or cancel a policy, because these are all 'underwriting' decisions."[7] Subsequently, in an interpretative letter, the FTC opined that the term "underwriting decision" included the case where an insurer would be obtaining credit reports on existing policyholders to determine whether they would be entitled to a discount under a Good Credit Discount Program upon renewal of existing policies.[8]

The use of credit scores in the mortgage lending industry and its potential impact on mortgage applicants have been addressed by the Federal Reserve System's Mortgage Credit Partnership Credit Scoring Committee. The Federal Reserve Bank of Chicago published an article in 2000 in which it outlined how credit scores are used in the mortgage application process and also addressed several related issues.[9] One such issue is that while credit scores can serve an important function to facilitate access to credit, their nature and usage could result in unlawful discrimination against minorities and low income applicants. This is generally referred to as the "disparate impact" of the use of credit scores.

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[5] Jim Guest, "High-rate robbery," *Consumer Reports*, Oct. 2002, p. 7.

[6] See [http://www.insurancescored.com], visited Dec. 8, 2004.

[7] Federal Trade Commission, "Statement of General Policy or Interpretation; Commentary on the Fair Credit Reporting Act," *Federal. Register*, vol. 55, no. 87 , May 4, 1990, pp. 18804, 18816.

[8] FTC letter to Mr. James M. Ball, dated March 1, 2000, available at [http://www.ftc.gov/os/statutes/fcra/ball.htm], visited Dec. 8, 2004.

[9] Michael V. Berry, "Perspectives on Credit Scoring and Fair Mortgage Lending," *Profitwise*, vol. 10, no.3, Fall 2000, at [http://www.chicagofed.org/publications/profitwise/2000/pwaug00.pdf].

Congress has continued to monitor the effectiveness of FCRA with interest peaking during the first session of the 108th Congress as portions of FCRA were set to expire at the end of 2003. Following a wide-ranging series of hearings and two markups, the House Financial Services Committee reported H.R.2622 amending the Fair Credit Reporting Act on July 25, 2003. While the FCRA's primary focus is on the regulation of credit information, the usage of this information, particularly insurance scores, by insurers drew congressional interest. Congressman Gutierrez previously introduced H.R.1473 to specifically regulate insurers' use of credit information and he offered an amendment at the subcommittee markup of H.R.2622 calling for a study of insurer usage of credit information. This amendment was accepted and included in the bill as reported from the full committee. The Senate held hearings and passed a bill amending the FCRA, S. 1753, after the House. This bill also included the requirement for a slightly different study on the usage of credit information in insurance. The conference committee made further slight changes to the study requirement and it was included in the conference report as passed and signed by the President (P.L. 108-159).

State Regulatory Aspects

Unlike banks and other financial institutions that are regulated primarily at the federal level, insurers are regulated primarily at the state level.[10] Most state insurance laws prohibit unfair trade practices, and also require that insurance rates not be unfairly discriminatory. Many states require prior approval of insurance premium rates, especially those for personal lines such as automobile and homeowners insurance. State lawmakers are beginning to turn their attention to the issue of insurers' using credit-based insurance scores in making underwriting, marketing, and rating decisions. According to the National Association of Mutual Insurance Companies (NAMIC), 48 states have taken legislative or regulatory action addressing insurer use of credit history information.[11] Many of the state laws are following a model law[12] recommended by the National Conference of Insurance Legislators (NCOIL) and generally supported by insurers. The law was described in congressional testimony[13] as requiring "insurers:

- to notify an applicant for insurance if credit information will be used in underwriting and rating;
- to notify a consumer in the event of an adverse action based on credit information, including notification of factors that were the primary influences on the adverse action;
- to re-underwrite and re-rate a policyholder whose credit report was corrected;

[10] For additional information on the background of state regulation of insurance, see CRS Issue Brief IB10106, *Insurance Regulation and Competition: Background and Issues*, by Baird Webel.

[11] NAMIC On Line, "Laws Governing the Use of Credit-based Insurance Scoring," available at [http://www.namic.org/reports/credithistory/credithistory.asp], visited Dec. 8, 2004.

[12] The text of this model can be found at [http://www.ncoil.org/other/CreditScoringModel.doc].

[13] Gregory V. Serio, "Testimony of the National Association of Insurance Commissioners," U.S. Congress, House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *The Fair Credit Reporting Act: How it Functions for Consumers and the Economy*, 108th Cong., 1st sess., hearings, June 4, 2004, p. 5.

- to indemnify insurance agents/brokers who obtained credit information and/or insurance scores according to an insurer's procedures and according to applicable laws and regulations;
- to file its scoring models with the applicable state department of insurance; such filings are deemed trade secrets."

Although described by a prominent consumer group as improving upon the previous market practices, the NCOIL law is seen as far from the prohibition on use of credit scores that some would prefer.[14]

State insurance regulators are also increasing their regulatory oversight over credit-based insurance scores. In some states, the regulators have already addressed the issue, but in an effort to develop a more unified national approach, most regulators are working through their trade organization, the National Association of Insurance Commissioners (NAIC). In March 2002, the NAIC appointed a credit scoring working group to focus on the various regulatory issues related to the use of credit information in the insurance underwriting and rating process. The working group has drafted documents to aid insurance consumers, and to assist the regulators in clarifying the issues and recommending a set of best practices. Two draft documents were cited in NAIC congressional testimony[15] and approved by the full NAIC shortly thereafter:

- *Consumer Brochure: Understanding How Insurers Use Credit Information*: This is a question/answer brochure, addressing such matters as the legality of an insurer's obtaining a credit report under FCRA without permission, why and how insurers use credit information, and how to improve one's insurance score.
- *Credit-Based Insurance Scoring: Regulatory Options*: This document seeks to set forth the pros and cons of various regulation options, including a ban on the use of credit history for rating purposes.

These two documents, however, did not complete the recommendations or policies some hoped would emanate from the working group and the NAIC. A study on the possible disparate impact of credit scoring was proposed. This proposed study, however, provoked significant debate and opposition. The working group cancelled a previously scheduled session at the regular NAIC summer national meeting that was held June 21-24, 2003.[16] At the NAIC fall national meeting, held September 13-16, 2003, this study was put off and it was suggested that concerned states should do studies of their own.[17] Indiana, Louisiana, Maryland, Missouri, Montana, Nevada, Oregon and Washington

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[14] See "Comments of Birny Birnbaum On Behalf of the Center for Economic Justice Before the National Conference of Insurance Legislators," available at [http://www.cej-online.org/ncoil_cr_scoring_testimony_021121.pdf], visited Dec. 8, 2004.

[15] Serio, pp. 9-10.

[16] See, for example, "Industry Brandishes New Credit Score Study," *Insurance Chronicle*, June 30, 2003, pg. 1.

[17] See "Credit-based Insurance Scoring Laws Gained Ground in 2003," *BestWire*, Dec. 31, 2003 and "U.S. Supreme Court Turns down Allstate's Insurance-score Lawsuit Appeal," *BestWire*, Apr. 27, 2004.

planned such a study, eventually abandoned the effort under the threat of litigation from the industry.[18] More recently, the NAIC working group produced a white paper with a set of "best practices" relating to the usage of credit scoring.

Litigation

A number of lawsuits have been filed alleging violations of either state or federal law relating to the usage of credit information. For example, a lawsuit against Allstate was filed seeking class action status in U.S. District Court in San Antonio, Texas, by several minority plaintiffs alleging that the insurer used information from credit reports and improperly factored it into a secretive scoring formula to target non-whites for more expensive policies than similarly situated whites. Allstate's motion to dismiss was denied, and the case as been allowed to proceed after successive appeals to the 5th U.S. Circuit Court and the U.S. Supreme Court. Insurers are concerned that the case could lead to a determination of a new discrimination standard over and above the state law prohibiting unfair discrimination, and thus usurp the authority of state insurance regulators and state laws.[19]

Allstate is not the only insurer who has been to court on such an issue. In Illinois, a suit alleged that State Farm had engaged in the practice of refusing to issue or renew insurance policies solely on the basis of a credit report, in violation of the Illinois Insurance Code.[20] In Texas, the attorney general sued Farmers Insurance Group, alleging, among other charges, that the insurer was "using credit history as a significant factor in setting premiums, without disclosing the adverse impact of doing so...."[21] A settlement was reached in the Texas case in December 2002, but it was challenged by some Texas policyholders.[22]

[18] Daniel Hays, "States Drop Plans For Study Of Credit Scoring," *National Underwriter, Property & Casualty/Risk & Benefits Management Edition,* Aug.9, 2004, pg. 6.

[19] Daniel Hays, "Federal Credit Score Case Unnerves Insurers," *National Underwriter Online Property & Casualty/Risk & Benefits Management Edition,* Oct. 14, 2002, p. 26.

[20] "State Farm Hit with Lawsuit over Credit-based Insurance Scoring," *BestWire*, June 12, 2002.

[21] The State of Texas v. Farmers Group, Inc. pg. 4, available at [http://www.oag.state.tx.us/notice/farmers080502.pdf],visited Jan. 20, 2003.

[22] R.A. Dyer, "Court holds up Farmers accord," *Fort Worth Star-Telegram*, July 9, 2003.

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